Missouri Law Review

Volume 41
Issue 3 *Summer 1976*
Article 18

Summer 1976

Securities Regulation--Share Exchange Pursuant to Corporate Reorganization Not a Purchase of Sale

Paul V. Herbers

Recommended Citation

Paul V. Herbers, *Securities Regulation--Share Exchange Pursuant to Corporate Reorganization Not a Purchase of Sale*, 41 Mo. L. Rev. (1976)
Available at: https://scholarship.law.missouri.edu/mlr/vol41/iss3/18

tional basis standard of review strikes an equitable balance between the interests of the community and the interests of the individual property owner.[36] By giving a strong presumption to local officials' findings of special benefits, it permits the city to rely on a stable revenue source in planning and executing local improvements. The spectre of suddenly having to find money in the general revenue fund to pay for a street improvement because of a judge's hindsight determination that the city council erred in its findings of fact is largely removed. Yet property owners retain the right to have the courts overturn a particular assessment where they can show that there is no reasonable theory which could have justified a finding of special benefits.

JAMES W. ERWIN

SECURITIES REGULATION–SHARE EXCHANGE PURSUANT TO CORPORATE REORGANIZATION NOT A "PURCHASE OR SALE"

In re Penn Central Securities Litigation[1]

The New York Central Railroad Company merged with the Pennsylvania Railroad Company in 1968 to form the Pennsylvania New York Central Transportation Company. The name was later changed to Penn Central Company (Penn Central). On April 1, 1969, the Penn Central Holding Company (Holding Company) was organized. On May 13, 1969, the shareholders of Penn Central approved a merger and reorganization[2] whereby all their stock in Penn Central was given to Holding Company in return for the stock of Holding Company. Penn Central, now a wholly-owned subsidiary of Holding Company and Holding Company's only asset, was renamed the Penn Central Transportation Company (Railroad) several months later.[3] In June 1970, Railroad began reorganization proceedings pursuant to section 77 of the Bankruptcy Act. The plaintiff-shareholders brought numerous actions under the Securities Exchange Act of 1934,

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special benefits may, in a particular case, be based on a myth rather than fact. Nevertheless, it upheld the assessment. McQuiddy v. Smith, 67 Mo. App. 205 (K.C. Ct. App. 1896).

36. Comment, *Special Assessments for Road Improvement Projects in Michigan—What Standard of Trial Court Review?*, 20 WAYNE L. REV. 1073, 1091-96 (1974).

1. 494 F.2d 528 (3d Cir. 1974).

2. The court did not attempt to distinguish between a merger and a reorganization, and no such distinction will be made in this note.

3. The facts are somewhat more complex than above stated. For a complete description of the procedure used for bringing about the reorganization, see *In re* Penn Central Securities Litigation, 335 F. Supp. 1026, 1030-1031 (E.D. Pa. 1971). The result was that Holding Company had all the stock of Railroad, and the public owned the stock of Holding Company.

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alleging that fraudulent and misleading financial information and proxy materials were released in connection with the approval of the reorganization.[4] The defendants[5] argued that section 10(b) of the Act[6] was not violated because the merger and reorganization did not constitute a "purchase or sale" for purposes of that section. The Third Circuit, affirming the granting of summary judgment for the defendants at the trial level,[7] held that the merger and reorganization could not be considered a purchase or sale within the meaning of section 10(b).

Rule 10b-5, promulgated by the Securities Exchange Commission pursuant to section 10(b), broadly forbids fraudulent or misleading practices in securities transactions.[8] Both the section and the rule, however, apply only to activity "in connection with the purchase or sale of any security." The normal 10(b) case involves some transaction in securities which fits the common law notion of a purchase or sale,[9] although other types of transactions have been held to come within the section and the

4. The opinion discussed sections 10(b) and 13(a) of the Act. The section 13(a) claim was dismissed by the court and will not be discussed in this note.

5. The defendants included certain companies in the Penn Central complex, a number of their present and former officers and directors, and certain independent accountants.

6. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale or any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

7. The appellate decision is a review of two district court cases: *In re* Penn Central Securities Litigation, 357 F. Supp. 869 (E.D. Pa. 1973); *In re* Penn Central Securities Litigation, 347 F. Supp. 1327 (E.D. Pa. 1972).

8. Although the instant case discussed only section 10(b) of the Act, rule 10b-5 is necessarily limited by any restrictions placed on the section by the courts. The rule's purchase or sale requirement cannot be relaxed unless the restriction is relaxed in regard to section 10(b) itself. Rule 10b-5, 17 C.F.R. 240.10b-5 (1973), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.

9. *See, e.g.*, Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), *cert. denied,* 389 U.S. 977 (1967), *rev'g* 267 F. Supp. 508 (N.D. Ill. 1966); Hooper v. Mountain State Securities Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961).

rule.[10] Contrary to prior decisions,[11] it is now clear that the surrender or issuance of securities in a merger is a purchase or sale for purposes of section 10(b).[12]

The court in *Penn Central,* in determining whether the section applied to the corporate reorganization, did not reach the issue whether the plaintiffs themselves were purchasers or sellers in connection with the alleged fraudulent scheme.[13] Rather, it faced the issue whether a purchase or sale had in fact occurred.[14] The plaintiffs' argument that there was a purchase or sale rested on their claim that the reorganization resulted in three significant changes in their interests as shareholders: (1) loss of their rights to an appraisal of their stock; (2) an inability to intervene in bankruptcy proceedings of Railroad; and (3) opportunities available for diversification by Holding Company which were not previously available to Penn Central (now Railroad).

Loss of appraisal rights has been the basis for finding a purchase or sale in prior cases. *SEC v. National Securities, Inc.,*[15] which involved a contemplated merger of two insurance companies and resultant loss of appraisal rights, held that shareholders of the acquired firm "purchased" shares in the new company by exchanging them for their old stock. In

10. *See, e.g.,* Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964), where a corporation issuing its own shares was deemed a seller.

11. National Supply Co. v. Leland Stanford Jr. University, 134 F.2d 689 (9th Cir.), *cert. denied,* 320 U.S. 773 (1943). In *National Supply Co.* the court stated that consolidation does not involve a sale of securities or an exchange amounting to a sale, accepting the SEC's argument as *amicus curias* without discussion. *See* Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied,* 389 U.S. 977 (1967), *rev'g* 267 F. Supp. 508 (N.D. Ill. 1966). In *Dasho* the SEC reversed its position, arguing as *amicus* that an exchange of shares pursuant to a merger is a sale so that the antifraud sections of the Act apply.

12. *See, e.g.,* Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6 (1971); Smallwood v. Pearl Brewing Company, 489 F.2d 579 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974); Levin v. Great Western Sugar Co., 406 F.2d 1112 (3d Cir.), *cert. denied,* 396 U.S. 848 (1969). Actually, corporate mergers have generated relatively little litigation involving rule 10b-5. The probable reason is the careful preparation which precedes the normal merger. There was no pertinent authority found by any party to the Penn Central litigation or by the district or appellate courts dealing with corporate reorganizations under the provisions of section 10(b). *See generally* A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 at § 6.5 (1968).

13. Whether the plaintiffs are purchasers or sellers in connection with the alleged fraudulent scheme is determinative of whether they have standing to bring an action under the section or the rule. *See* Blue Chip Stamps v. Manor Drug Stores, 95 S. Ct. 1917 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 945 (1952). For a discussion of the distinction between this issue and the issue whether a purchase or sale has in fact occurred, see *SEC Rule 10b-5—"In Connection with the Purchase or Sale of any Security" Restriction: Need for Analytical Precision,* 5 COLUM. J. OF L. & SOC. PROB. 28 (August 1969).

14. The court said that it need not decide the *Birnbaum* issue, 494 F.2d at 533, possibly confusing the distinctions of coverage under the rule and standing under the rule and section. *See* note 13 *supra.* There are numerous instances where the exchange of shares itself does not constitute a purchase or sale because it is only incidental to an internal management decision—*e.g.,* stock split, reverse stock split, creation of a new class of stock, or change in par value. 494 F.2d at 534.

15. 393 U.S. 453 (1969).

Vine v. Beneficial Finance Company[16] a shareholder who was given the alternative rights, in a short form merger, to exchange his shares for cash or seek an appraisal, was held to be a "seller" who could assert a cause of action for deceptive practices under the Act.[17]

In *Penn Central* four days prior to the date of the meeting in which the reorganization was approved, the board of directors of Penn Central elected to have the corporation governed by the Pennsylvania Business Corporation Law (BCL).[18] One result of this election was the immediate loss of appraisal rights for dissenting shareholders, because such rights were not available under the BCL. The shareholders contended that consideration of this loss contributed to making the vote for or against reorganization a significant investment decision. The court, however, noting that the board of directors had complete authority to make the election at any time, decided that any appraisal rights which had existed prior to the voting for reorganization were eliminated by the BCL election rather than by the reorganization.[19] Therefore, appraisal rights were irrelevant to the shareholders' vote, and a determination whether loss of such rights would require a significant investment decision was unnecessary. The *Penn Central* court distinguished *National Securities* on the ground that any loss of dissenters' appraisal rights in the latter case was a result of shareholder approval of the merger, rather than a result of the independent action of the directors.

The standard which the court applied is whether the shareholder interest involved transformed the voting decision into an investment decision. If a significant investment decision is involved, a purchase or sale can be found. Had the election not been made before the shareholder vote, there would have been a significant investment decision, because then the shareholders could have considered a loss of appraisal rights in casting their votes. If the "investment decision" standard is a good one, then the conclusion reached by the *Penn Central* court was correct, because nonexistent rights could hardly affect the votes. One possible problem with this line of reasoning, however, is that the election for BCL coverage was probably a prerequisite to bringing about the reorganization.[20] If this were so, then the election would seem to be more important than

16. 374 F.2d 627 (2d Cir. 1967). *See* Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right,* 77 HARV. L. REV. 1189 (1964).

17. *See also* Voege v. American Sumatra Tobacco Corporation, 241 F. Supp. 369 (D. Del. 1965), in which a purchase or sale was found where there was a loss of appraisal rights in a corporate merger. *But see* Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 234 (D. Neb. 1972). "The shareholders of the *surviving* corporation [to a merger], however, are not sellers of securities unless a sale is made pursuant to dissenters' rights." *Id.* at 238.

18. PA. STAT. tit. 15, § 1001 *et seq.* (1967). Before the election by the directors, Penn Central was excepted from coverage of the BCL as a carrier. PA. STAT. tit. 15, § 1004 (B)(2) (1967). The election merely made different provisions of Pennsylvania law applicable.

19. The court found it unnecessary to decide whether appraisal rights existed originally.

20. The court mentioned this without discussion. 494 F.2d at 536.

the typical internal management decision, which is considered to be outside the scope of section 10 (b).[21]

The second argument advanced for finding a purchase or sale was that the reorganization resulted in the shareholders' loss of rights to participate in bankruptcy proceedings of Railroad.[22] The court admitted that the loss of these rights might affect an investment decision, but then decided that such an effect would not be significant. "The weight to be given [these considerations] depends upon the value a shareholder would reasonably attach to them in determining how to cast his vote on the proposed reorganization . . . ."[23] In casting a vote for the reorganization, the shareholder would have to weigh the probable joint occurrence of: (1) a highly remote and speculative bankruptcy; (2) not being in control of Holding Company and therefore unable to be heard in bankruptcy proceedings as a matter of right; and (3) discretionary denial of the opportunity to be heard as a minority in the bankruptcy proceedings. The probability of these occurrences was believed to be so small that it would be unlikely that any individual shareholder, in casting his vote, would consider them. Therefore, the court determined that the "loss of [such] rights deserves minimal weight."[24]

The court's language indicates that the loss of the right to be heard in bankruptcy may, under certain circumstances, cause a reorganization to be considered a purchase or sale. Where the likelihood of bankruptcy is high, a shareholder vote on reorganization would be a significant investment decision, because a shareholder would reasonably be concerned about his future opportunity to be heard in bankruptcy proceedings. Even where the probability of bankruptcy is slight, and the corresponding effect on the investment decision in minimal, the loss of participation rights may be considered in conjunction with other affected interests in concluding that the voting decision was a significant investment decision. That is, considerations which alone deserve minimal weight may in combination be of significant importance to a shareholder in making his investment decision.

The remaining argument of the plaintiffs was that the reorganization provided an opportunity not previously available for diversification into nonrailroad areas of business.[25] Although opportunity to diversify was not a

21. *See* Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

22. Under the Bankruptcy Act, 11 U.S.C. § 205 (c) (13) (1970), only shareholders have the right to be heard in such proceedings, and after the reorganization in this case all of Railroad's stock was held by Holding Company. Participation by the shareholders of Holding Company in the proceedings was a matter for the discretion of the reorganization court. Furthermore, as non-shareholders they apparently could no longer combine claims so that joint holdings might be sufficient to justify intervention by a representative.

23. 494 F.2d at 537.

24. *Id.*

25. Before the reorganization, Railroad as a carrier could not issue any securities without first obtaining the approval of the Interstate Commerce Commission. 49 U.S.C. § 20a (1970). Formation of a holding company would open up

certainty, it was sufficiently probable to be a consideration for the shareholders when they cast their votes. The court acknowledged the potential importance of this consideration, but, again, dismissed it as being in the nature of internal corporate restructuring. The court reasoned that this kind of diversification would be handled in the typical corporation by an amendment to the articles of incorporation,[26] and the only reason it was done differently in this case was because of the statutory restrictions applied to railroads. The elements entering into the decision of the shareholders in *Penn Central* were said to be the same as those typically confronting any shareholder voting on the enlargement of the charter purposes of his corporation.

This reasoning, however, is not completely persuasive. The facts should be considered as they occurred rather than as they might have occurred. The question whether there was a significant investment decision involved was not discussed. Clearly, diversification potential could be a primary consideration for shareholders, which would allow the finding of an investment decision as a basis for a purchase or sale. The court instead focused on the result of the decision—the restructuring of an existing corporation with no significant change in assets. So, even though a shareholder vote was necessary and investment considerations were involved, it was found to be in the nature of an internal management decision, because it might have been handled differently.

The ultimate issue, as phrased by the court, was whether the reorganization was in effect an "internal corporate management decision" which only incidentally involved an exchange of shares, or whether it was a major corporate restructuring requiring the same kind of "investment decision" by the shareholders as would a proposed merger with a separate existing corporation.[27] Although the result reached by the court seems desirable, its conclusions from the application of this test to at least two of plaintiffs' arguments are questionable. Loss of ability to participate in bankruptcy proceedings could well have reasonably affected an investment decision, but this consideration was dismissed because of the speculative nature of that loss. The court simply concluded that loss of participation rights was an outgrowth of an internal management decision rather than one typically following from a sale of shares or a merger of two corporations. Failure to consider the reorganization as a significant investment decision involving potential for diversification is even more questionable. The fact that a transaction could have been completed by corporate management in a manner other than a shareholder vote should not of itself preclude a finding of a purchase or sale.

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the possibility that the ICC might decline jurisdiction over Holding Company's issuance of securities, thus allowing diversification. 49 U.S.C. § 5 (3) (1970).

26. Internal corporate action amending the articles of incorporation would not be in the nature of a "purchase or sale" of stock in one corporation for stock in another corporation. 494 F.2d at 539.

27. 494 F.2d at 534.

The court apparently believed that this type of reorganization did not involve enough of a change in shareholder interests to be considered a purchase or sale—*i.e.*, it is a matter of degree.[28] If the test for finding a purchase or sale is whether the change of interest was in the nature of an "internal management decision" as opposed to a "significant investment decision" of the shareholders, then it will be a difficult one to apply. The problem in *Penn Central* is that the court appeared to use these terms as conclusory labels in order to support a decision that was probably based on policy considerations.[29]

The requirement of a purchase or sale as a limitation on section 10 (b) actions is desirable for several policy reasons. Failure to limit section 10 (b) would transform it into a general federal law of corporate fiduciary duty. The section would quickly encroach on the area of traditional state common law liability for fraudulent mismanagement of corporate affairs.[30] There might also be an increase of vexatious litigation.[31] These results were not part of the congressional intent in section 10 (b).[32] Furthermore, Congress delegated responsibility to the SEC, and not to the courts, to promulgate rules under section 10 (b). The large amount of litigation

28. A number of cases restrict "purchase or sale" to the concept of consideration. *See, e.g.*, Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); Ingenito v. Bermec Corp., 376 F. Supp. 1154 (S.D.N.Y. 1974). Other cases suggest that the restrictive concept of consideration is not desirable. *See, e.g.*, Frigitemp Corp. v. Financial Dynamics Fund, Inc., _____ F.2d _____, CCH FED. SEC. L. REP. ¶ 95,323 (2d Cir. 1975); Hooper v. Mountain State Securities Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (stock in exchange for worthless assets was a sale, despite the fact that there was no consideration). The *Penn Central* court avoided analyzing the reorganization in terms of consideration.

29. The *Penn Central* court may have been influenced by International Controls Corporation v. Vesco, 490 F.2d 1334 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974), decided two months before the instant case, which confronted this issue in an analogous factual situation. The effects of the *Vesco* transaction on shareholder rights were not so great as those in the *Penn Central* reorganization, but both *Vesco* and *Penn Central* differ from the typical merger between two separate corporations, where the original shareholders of each corporation end up with stock in a substantially different company with substantially different assets and prospects.

The *Penn Central* court distinguished *National Securities* because the share exchange in *National Securities* accompanied the merger of two separate and distinct corporate entities. *But see* Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) (defendants controlled, but did not wholly own, all corporations to be merged, and a purchase and sale was found). *Cf.* Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954): "(T)he transaction was . . . a mere transfer between corporate pockets . . . . Until . . . some new individuals . . . enter the picture there has been no real sale of stock." 212 F.2d at 80.

30. *See* Ciechon, *The Decline of the Purchaser-Seller Requirement of Rule 10b-5*, 14 VILL. L. REV. 499 (1969); Bradford, *Rule 10b-5: The Search for a Limiting Doctrine*, 19 BUFFALO L. REV. 205 (1970).

31. This problem is considered in the *Birnbaum* context of standing in Blue Chip Stamps v. Manor Drug Stores, 95 S. Ct. 1917 (1975).

32. *See* Blue Chip Stamps v. Manor Drug Stores, 95 S. Ct. 1917, 1924 (1975); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 945 (1952).